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BEFORE THE
POSTAL REGULATORY COMMISSION
WASHINGTON, DC 20268-0001

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| Annual Compliance Report, 2015 | ) | Docket No. ACR2015 |
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**VALPAK DIRECT MARKETING SYSTEMS, INC. AND VALPAK DEALERS' ASSOCIATION, INC. INITIAL COMMENTS ON THE UNITED STATES POSTAL SERVICE FY 2015 ANNUAL COMPLIANCE REPORT**
(February 2, 2016)

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On December 29, 2015, the United States Postal Service ("USPS") filed its "United States Postal Service FY 2015 Annual Compliance Report" ("ACR"), which is required by 39 U.S.C. § 3652(a) to be filed within 90 days after the end of the fiscal year. On December 30, 2015, the Postal Regulatory Commission ("Commission") issued Order No. 2968, "Notice of Postal Service's Filing of Annual Compliance Report and Request for Public Comments," seeking initial comments by February 2, 2016, and reply comments by February 12, 2016. The Commission's Annual Compliance Determination ("ACD") is expected on March 28, 2016, pursuant to 39 U.S.C. § 3653(b).

Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. (hereinafter "Valpak") hereby submit these joint Initial Comments on the FY 2015 ACR in response to the Commission's Notice.

## I. STANDARD MAIL FLATS ARE NOT IN COMPLIANCE WITH PAEA, REQUIRING AN EFFECTIVE REMEDIAL ORDER FROM THE COMMISSION.

After several years of supposedly "remedial" pricing increases, Standard Mail Flats remain in FY 2015, in the same seriously money-losing situation that it was in when the Commission found the product to be out of compliance with the law in the FY 2010 ACD. The Commission's reasoning that led it to that earlier finding apply again this year, except with greater force. Moreover, it is now beyond question that the Commission's remedial order to the Postal Service has proven wholly ineffective and inadequate in achieving compliance within any period of time — to say nothing of a "reasonable" period of time.

Below, Subsection A sets out the growing losses from Standard Flats that plagued the Postal Service in FY 2015 as well as Standard Flats losses cumulatively for the better part of a decade. Subsection B addresses the growing cost of handling Standard Flats. Subsection C re-examines for this ACR the findings and assumptions made by the Commission in its FY 2014 ACD to justify issuing no further remedial order at that time. Subsection D considers the health of Standard Flats without exigent surcharge. Subsection E notes the failure of FSS pricing. Finally, Subsection F presents an indictment of the illegality of Postal Service Standard Mail pricing, and Subsection G requests the Commission to issue an effective remedial order in this docket.

### A. Standard Mail Flats Losses Continue to Increase in FY 2015.

In its FY 2010 ACD, the Commission determined that the Standard Mail Flats product was in violation of 39 U.S.C. § 101(d) because it **lost $582 million in FY 2010**, requiring other products to subsidize it rather than paying its way and making a contribution to institutional costs. Now, **after years of the remedial pricing steps** ordered by the Commission, that one product again **lost $522 million in FY 2015.**

This FY 2015 loss represents a **one-year increase in loss** from this one product of a remarkable **$111 million — or 27 percent** — over the **$411 million** loss in FY 2014. *See* Table I-1. It also represents a **39 percent** increase over the $376 million loss in FY 2013. Clearly, the product is headed in the wrong direction.

The Postal Service identifies 100 percent cost coverage of products — *i.e.*, not having one set of commercial mailers subsidize the mail of another set of commercial mailers — as an "appropriate long-term goal." ACR at 17. However, it has no plan to make that happen. The Postal Service identifies several operational efforts to improve coverage. *Id.* at 19-28. Together, however, these operational changes will have only a negligible effect on reducing the subsidy to Standard Flats. Despite the Commission's repeated pleas for some kind of estimate of the financial effect of the Postal Service's cost reducing efforts, "[t]he Postal Service is unable to provide an estimate of the financial impacts of these operational initiatives at this time." *Id.* at 19. The Postal Service's non-responses to Commission criticisms have worked before, and it apparently decided to try the same strategy one more time.

With respect to initiatives that might have the largest impact on reducing the Postal Service's costs, the Postal Service has delayed such initiatives, at least in some measure due to political pressure to maintain jobs. Specifically, the Postal Service has delayed phase 2 of its Network Rationalization "until 2016" but has not announced that the facility consolidations will be continuing anytime soon.[1] Congress has not offered to subsidize those excess facilities from the public fisc, while some have proposed legislation to put a moratorium on the Postal Service's mail processing network rationalization.[2]

The Postal Service appears to care little about the cumulative sum of money it has lost on underwater products over a multi-year period. Although it lists annual losses as ordered by the Commission, it quite understandably was reluctant to provide the Commission with the sum of those losses. Valpak is pleased to fill in that missing datum for the benefit of the Commission. *See* Table I-1.

> **Since 2008,** when the Postal Service first reported data using the new product categories under PAEA, **Standard Mail Flats has lost almost $3.9 billion**.

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[1] *See* https://ribbs.usps.gov/index.cfm?page=network_rationalization.

[2] *See* S. 2051, Improving Postal Operations, Service, and Transparency Act of 2015, 114th Cong.

**Table I-1**
**Standard Mail Flats Subsidies**

| Fiscal Year | Subsidy (millions) |
|---|---|
| 2008 | $217.8 |
| 2009 | $615.6 |
| 2010 | $577.0 |
| 2011 | $643.2 |
| 2012 | $527.9 |
| 2013 | $375.9 |
| 2014 | $411.0 |
| 2015 | $521.7 |
| Total: | $3,890.1 |

Source: ACR at 30.

The Postal Service quite believably advises the Commission that these losses on Standard Flats will continue. Under its pricing approach, as approved by the Commission, the Postal Service concludes with typical understatement: "it is unlikely that the shortfall will be eliminated by the end of 2016…." ACR at 30.

In truth, unless the Commission acts decisively in this Annual Compliance Determination with a meaningful remedial order,[3] Standard Flats will need to be subsidized for as long as forecasts can reasonably be made.

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[3] The Commission does not have the latitude to find a violation and ignore it. Once the violation is found, it has a duty to fix it. *See* Gamefly, Inc. v. Postal Regulatory Commission, 704 F.3d 145, 149 (D.C. Cir. 2013) and discussion in Docket No. ACR2014, Valpak Initial Comments, Section VII.

### B. The Unit Cost of Standard Flats Worsened in FY 2015, and No Meaningful Cost Reduction Has Been Identified by the Postal Service.

Cost data submitted in this year's ACR show another **increase in the unit cost** of Standard Flats.[4] It now appears quite possible that full deployment of FSS machines to date has had no effect on the end-to-end unit cost of Standard Flats, or may even have caused a slight increase in unit cost.

Hopefully, the unit cost of Standard Flats will not increase further in FY 2016, but a further increase in unit cost should be regarded as a distinct possibility for reasons discussed herein. The fact that the cost of handling Standard Flats has increased faster than other Standard Mail products is certainly no reason to mitigate price increases for Standard Flats. By now, it should be clear that the Postal Service cannot handle Standard Flats as inexpensively as it can letter-shaped and some other Standard Mail products, despite FSS deployment. Proper price signals need to be given to advertisers which reflect postal costs. (*See* Section II, *infra*.) At this juncture, Standard Flats are inherently a high-cost product, and prices for that product, like all products, at least need to cover those attributable costs, whatever they may be. In this year's ACD, it would be a welcome change to see the Commission's discussion focus on the reality of high Standard Flats costs rather than continuing to base decisions on the unsupported hope they might someday may be reduced.

Valpak is aware of and appreciates the Postal Service's assiduous efforts being made to control the cost of flat-shaped mail. Nevertheless, the FY 2015 CRA Report that was filed on December 29, 2015 reveals that the unit cost of flats has increased, and the price is father away

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[4] From 49.4 cents in FY 2014 to 50.1 cents in FY 2015.

from covering cost than ever before. Although it may be considered reasonable under the circumstances for flat-shaped mail to be temporarily relieved from making even a token contribution to the Postal Service's extensive institutional costs, Standard Flats nevertheless should, at a minimum be charged their attributable cost, without delay.

If the Commission desires the system of price cap regulation which it devised under the authority granted in PAEA to achieve success — where "success" is evidenced by noticeable improvement in the Postal Service's financial condition under its price cap, including more liquidity, and greater profitability and contribution — it needs to assert its regulatory authority and order a price increase for Standard Flats that will fully eliminate the subsidy within two years, during which time the Commission's 10-year review of PAEA will be completed. Otherwise, that review will be forced to acknowledge that price cap regulation, at least as devised and implemented by the Commission, has been a failure in eliminating cross-subsidies and preventing illegal pricing by the Postal Service.

### C. None of the Reasons Undergirding the Commission's Decision to Order No Further Remedial Action in the FY 2014 ACD Are Now Operative.

Valpak's Initial Comments in Docket No. ACR2014 went line-by-line through the Commission's justification for ordering no additional remedial action towards Standard Flats in the FY 2013 ACD. *See* Docket No. ACR2014, Valpak Initial Comments at III-8 – III-16. Those comments demonstrated how every factor that the Commission relied on for doing nothing in the FY 2013 ACD was either reversed in FY 2014 (such as lower unit costs) or turned out to be flatly wrong.

Nevertheless, the Commission somehow concluded:

> *The Commission finds that **progress is being made toward** addressing the issues it raised in the FY 2010 ACD. As a result, no further remedial action is required at this time. However, the Postal Service should **continue improving** cost coverage for Standard Mail Flats.* [FY 2014 ACD at 47 (emphasis added).]

Unlike its FY 2013 ACD which appeared to give reasons for its decision, however flawed, the Commission made no effort in its FY 2014 ACD to justify this wholly conclusory — if not fancifal — finding. The Commission then expressed its "concern[] that the product's financial performance has diverged from the positive trend demonstrated in the last two fiscal years," and ordered the Postal Service to "take **aggressive action** to reduce the unit costs or propose above-CPI price increases." Quite obviously, the Postal Service has done neither.

It is instructive to revisit the Commission's post-appeal order explaining its reasons for making its finding of noncompliance in the FY 2010 ACD, and ordering remedial action:

> From its review of Standard Mail Flats in the FY2007, FY2008, FY2009, and FY2010 ACDs, the Commission identified the following factors which, together, constituted circumstances that triggered section 101(d)'s failsafe protections: a significant and growing cost coverage shortfall; duration of the shortfall over a significant period; evidence that the cost coverage shortfall was likely to increase further; a significant adverse impact on users of other mail products (some of whom could be competitors of mailers of the subsidized mail product) requiring subsidization of the non-complying product; failure of the Postal Service to address the shortfall by rate increases, cost decreases, or a combination thereof, despite the capability to do so; and failure of the Postal Service to provide an adequate explanation for not taking necessary remedial steps designed to ameliorate the cost coverage shortfall. **Together, these factors were characterized by the Commission in its appellate brief as an "extreme case"**. 676 F.3d at 1107 (*citing* Respondent's Brief at 29). [Order No. 1427, p. 9 (emphasis added).]

We review the reasons the Commission gave then, and all the factors identified, when the Commission found noncompliance remain in FY 2010 to show they again are present in FY 2015. Although subsidized users of Standard Flats would prefer for the Commission to do nothing so that their gravy train can continue rolling on, the Commission cannot legally continue to do the same thing over and over and expect different results.

Consider the factors that the Commission found persuasive in FY 2010 and check off how many of them apply fully in FY 2015:

☐ "a significant and growing cost coverage shortfall":

✓ **$522 million** in FY 2015

☐ "duration of the shortfall over a significant period":

✓ annual losses in the **eight years** since FY 2008, totaling **$3.9 billion**

☐ "evidence that the cost coverage shortfall was likely to increase further":

✓ The Postal Service has no plan for cost savings adequate to address coverage, pricing plans will not be effective, the exigent surcharge will expire in April, and the Postal Service itself professes it has no timetable for eliminating the shortfall.

☐ "a significant adverse impact on users of other mail products (some of whom could be competitors of mailers of the subsidized mail product) requiring subsidization of the non-complying product":

✓ Other Standard Mail users — most of which are commercial mailers — pay coverages well in excess of average. However, for those mailers, some of their contribution to the Postal Service's institutional costs is being syphoned off by Standard Mail Flats and Parcels.

- ☐ "failure of the Postal Service to address the shortfall by rate increases, cost decreases, or a combination thereof, despite the capability to do so":

  ✓ The Postal Service has implemented barely above average prices for Standard Flats in the most recent price adjustments and even those have not kept up with the increase in costs. On the costs side, the Postal Service's efforts to decrease them have been inadequate or nonexistent as the costs continue to rise. Thus, despite the Postal Service's capabilities, its combination of rate increases and cost decreases have failed to reverse the shortfall.

- ☐ "failure of the Postal Service to provide an adequate explanation for not taking necessary remedial steps designed to ameliorate the cost coverage shortfall":

  ✓ The Postal Service's only explanation in its ACR is that "it is very difficult to predict when the shortfall for Standard Mail Flats will be phased out," but it will not be eliminated by the end of FY 2016. *See* FY 2015 ACR at 30.

If these six factors taken together were sufficient to mandate triggering § 101(d)'s failsafe provisions in FY 2010, then the same must be true in FY 2015. The Commission considered FY 2010 Standard Flats an "extreme case," and if it does not do so again now, the Administrative Procedure Act would require that it set out a principled rationale for a reversal of position. *See, e.g.*, Mfrs. Rw'y Co. v. Surface Transportation Board, 676 F.3d 1094, 1096 (D.C. Cir. 2012)

### D. The Commission Should Consider How Standard Flats Losses will Grow if and When the Exigent Surcharge is Removed.

The Postal Service is expected to reach the exigent surcharge revenue cap in early April 2016. *See* Docket No. R2013-11, Order No. 3030 (Jan. 15, 2016). Unless Congress intervenes, the Postal Service will obviously have to learn to live with reduced revenues. Products that are underwater now will become evern further underwater. What is unfair and illegal pricing today will become even more unfair and illegal pricing in April and thereafter.

To provide a perspective of the health of the Standard Flats and Carrier Route products, it is important to understand how they will fare after removal of the surcharge, by reviewing FY 2015 coverages with and without the exigent surcharge revenues while the rest of these comments assess the Standard Flats product separately, these two products are considered together here for two reasons:

> First, the Postal Service's price changes in Docket No. R2015-4 shifted some flats-shaped volumes from Carrier Route to Standard Flats.[5] As it turns out, even this manipulation of profitable volume into an unprofitable subclass has done little to obscure the Postal Service's losses. It is very difficult to hide losses this large. (*See* Section I.E., *infra*.)

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[5] See Commission Order No. 2472 (May 7, 2015), Docket No. R2015-4, at 46-47, addressing Valpak argument as to how this shift would obscure losses from Standard Flats. Even as recently as May 2015, in the last general pricing docket, the Commission exhibited optimism about coverage, which has now, again, been proven unjustified: "Combined with cost reduction initiatives, the proposed price increase is likely to increase cost coverage for Standard Mail Flats." *Id.* at 35.

Second, although Valpak has always taken the position that each product must stand on its own,[6] and the Commission has adopted that view,[7] the American Catalog Mailers Association has repeatedly stated[8] that these two products should be viewed together, and that since they together cover their attributable costs, that it should be irrelevant that Standard Flats lose hundreds of millions of dollars annually. Well, we doubt that ACMA will be making that argument again in this docket, for when the exigent revenue is removed mid-FY2016, coverage of the ACMA-recommended "combined" catalog Flats/Carrier Route product goes negative, under current Postal Service pricing. Obviously, if the price cap continues to be near zero, in FY 2017, when the Postal Service will not have any benefit from exigent revenue, these losses will only increase.

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[6] Valpak Reply Comments, Docket No. ACR2012 at 8-11.

[7] FY 2012 ACD at 116.

[8] *See, e.g.,* ACMA Initial Comments, Docket No. ACR2014, at 3-5 (proudly reporting a combined cost coverage of 114 percent, as of that time).

Table I-2
FY 2015 Standard Mail Revenues[9] and Coverages
Carrier Route and Flats
(millions)

| | Contribution, actual | Coverage | Contrib. w/o exigent revenue, Pro forma | Coverage without exigent revenue |
|---|---|---|---|---|
| Carrier Route | $530.2 | 131.1% | $436.2 | 125.6% |
| Flats | $-521.7 | 80.2% | $-603.2 | 77.0% |
| Combined | $8.5 | 100.2% | $-167.0 | **96.1%** |

Source: Columns 1 and 2, FY 2015 CRA; column 3 = column 1 less exigent surcharge revenue from the four quarterly revenue reports filed in Docket No. R2013-11.

However, focusing only on the Standard Flats row in Table I-1, which is the proper method of analysis, the Commission must issue a strong remedial order, even if Congress extends the surcharge, to address the financial health of Standard Flats in FY 2015, which was horrible.

### E. FSS Has Not Resulted in Cost Improvements and FSS Pricing Has Failed to Improve Coverages.

In Docket No. R2015-4, the Postal Service introduced discounted FSS pricing for flat-shaped Standard Mail. The FSS prices for flat-shaped pieces were placed in the Standard Flats product, transferring some volumes from the Carrier Route product to Standard Flats. Carrier Route has been a profitable product for the Postal Service since it started using the product categories after PAEA.

It was assumed that the combination of (i) the FSS discounts would increase flats processing on the FSS, thus reducing costs, and (ii) the transfusion of profitable Carrier Route

[9] Exigent revenues for the two products are from the four FY 2015 quarterly exigent surcharge revenue collection reports filed in Docket No. R2013-11.

pieces would result an overall improvement in Standard Flats' cost coverage. Those assumptions have proven illusory.

Reducing the cost of processing and delivering flats is, at least theoretically, part of the solution. However, as this year's ACR points out, all FSS machines became operational by the end of FY 2011. In the four intervening years, the fleet of FSS machines has not been able to effect any measurable reduction in the end-to-end cost of flats. Using the FSS to finalize presort Carrier Route mail may even have resulted in a small cost increase. If the Commission wants to speculate about possible reductions in the unit cost and increases in the coverage of Standard Flats, Valpak suggests the Commission first require the Postal Service to submit a roll-forward model that incorporates known events such as contractual wage increase and removal of the exigent surcharge.

The FSS pricing shifted significant volumes from Carrier Route to Standard Flats. As a result, volume increased for Standard Flats, but for a product with negative unit contribution, *i.e.*, for a subsidized product, volume growth results in greater losses. The Postal Service acknowledges this basic economic concept: "the volume of Standard Mail Flats actually grew in FY 2015, and when unit contribution is negative, volume growth will necessarily increase the aggregate contribution shortfall." ACR at 30-31.

## F. STANDARD MAIL PRICING VIOLATES PAEA AND 39 U.S.C. SECTION 101(d).

### 1. The Disparity in Cost Burden Among Standard Mail Products Is Large and Growing.

The statutory requirement to "apportion the costs of all postal operations to all users of the mail on a fair and equitable basis" (39 U.S.C. § 101(d)) applies to every class of mail — and to products within classes. *See* Section II, *infra*.

Standard Mail, by definition, is mail that is not required to be sent as First-Class Mail or as Periodical class mail. *See* DMM section 243.2.1. Thus, "Standard Mail is typically used for advertisements and flyers." DMM QSG 240b. Since almost all users of Standard Mail are advertisers, one would expect that the coverage of all Standard Mail products would be within a reasonably narrow range, and that the Postal Service could articulate a reasoned basis (*e.g.,* markedly different elasticities) for any significant diversion. Nothing, however, could be further from the truth.

Enormous disparities in coverage exist. Furthermore, generally speaking, the disparities are getting worse, not better. Certain advertisers that use Standard Mail products that the Postal Service can process and deliver efficiently and inexpensively are being forced to pay higher prices so that other advertisers (sometimes their competitors) may choose costly to handle, yet underpriced, products. This is the very definition of unfair and inequitable.

### 2. Disparities in Coverage.

The FY 2015 ACR sets out the Standard Mail volumes, revenues, and costs for each product in Table 2 (p. 17). As usual, that table does not present the coverage trends for each Standard Mail product, although the Postal Service does provide year-over-year comparisons for the two underwater products, Standard Flats and Parcels. *Id.*, pp. 18-19. Examination of multi-year trends across all Standard Mail products better reveals what has been happening. Table I-3, *infra*, shows the four-year change (FY 2012 to FY 2015) of the cost coverages of each of the Standard Mail products.

**Table I-3**
**Standard Mail Products**
**Cost Coverage**
**(FY 2012-FY 2015)**

| | FY 2012 | FY 2013 | FY 2014 | FY 2015 | Change FY 2012-FY 2015 (Percentage Points) |
|---|---|---|---|---|---|
| **HD/Sat Letters** | **222.2%** | **235.8%** | **238.0%** | 218.5% | - 3.7 |
| HD/Sat Flats & Parcels | 217.3% | 229.0% | 227.6% | 173.3% | - 44.0 |
| Carrier Route | 130.8% | 133.4% | 140.2% | 131.1% | 0.3 |
| Letters | 178.9% | 189.0% | 200.5% | 203.3% | 24.4 |
| **Flats** | **80.9%** | **84.9%** | **81.6%** | 80.2% | - 0.7 |
| Parcels | 85.5% | 64.3% | 66.3% | 72.8% | - 12.7 |
| EDDM-R | N/A | 359.9% | 379.1% | 287.9% | N/A |
| Standard Mail | 149.0% | 159.9% | 166.1% | 159.8% | 10.8 |

Two Standard Mail products were deeply underwater in FY 2015 — with Standard Flats having a 80.2 percent coverage and Parcels having a 72.8 percent coverage (despite a 9.5 percent price increase last year). Some other Standard Mail products have extremely high coverages (*e.g.*, 218.5 percent for HD/Saturation Letters). Over the period of the last four years, coverage of the two underwater products actually has decreased:

- Standard Parcels' coverage has dropped by 12.7 percentage points;

- Standard Flats' coverage has decreased by 0.7 percentage points (despite supposedly "above-CPI" increases).

### 3. Disparities in Unit Contribution.

The issue of "fair" and "equitable" pricing also should be examined from the standpoint of changes in unit contribution. Table I-4, *infra*, sets out changes in unit contribution over three years for all Standard Mail products.

**Table I-4**
**Standard Mail Products**
**Unit Contribution (marginal revenue)**
**(FY 2012-FY 2015)**
**(cents)**

| | FY 2012 | FY 2013 | FY 2014 | FY 2015 | Change FY 2012-FY 2015 | Percentage Change |
|---|---|---|---|---|---|---|
| **HD/Sat Letters** | **7.5** | 8.1 | 8.5 | **8.3** | 0.8 | **10.7%** |
| HD/Sat Flats & Parcels | 8.9 | 9.6 | 10.0 | 7.7 | -1.2 | **-13.5%** |
| Carrier Route | 5.7 | 6.2 | 7.6 | 6.4 | 0.7 | 12.3% |
| Letters | 8.5 | 9.3 | 10.3 | 10.7 | 2.2 | 25.9% |
| **Flats** | **-9.0** | -6.8 | -9.1 | **-9.9** | -0.9 | **-10.00%** |
| Parcels | -17.5 | -54.0 | -52.5 | -40.2 | -22.7 | -129.7% |
| EDDM-R | N/A | 10.3 | 12.3 | 11.6 | N/A | N/A |
| Standard Mail | 6.9 | 7.9 | 8.7 | 8.3 | 1.4 | 20.3% |

Standard Mail Flats unit losses improved significantly in FY 2013, but then reversed direction, increasing from 6.8 cents 1to 9.9 cents in FY 2015, more than wiping out all the gains made in FY 2013. To put it another way, the Postal Service loses a dime for every piece of Standard Flat it handles. These increased losses occurred despite the 4.3 percent exigent (above CPI) price increase.

The other notable feature about Table I-4 is that unit contribution from **HD/Saturation Letters** has **grown by 10.7 percent**, while unit contribution from its sister product, **HD/Saturation Flats,** has **dropped by 13.5 percent**. There is no possible justification for this disparity.[10] Until the coverage and unit contribution of the two saturation products are normalized, there should be no increases whatsoever for HD/Saturation letters.

Furthermore, applying the method of analysis used by the Commission in its FY 2013 ACD (at 54), Table I-5, *infra*, demonstrates that the **unit contribution gap** between Standard Flats and all of the other profitable products **widened**, not narrowed, since FY 2013.

[10] Some of this worsening disparity was created by the Postal Service which gave HD/Saturation Letters an above-average price increase (1.979 percent), while giving HD/Saturation Flats a below-average price increase (1.796 percent) in the last price increases. *See* Order No. 2472, Docket No. R2015-4 at 33.

**Table I-5**
**Standard Mail Products**
**"Unit Contribution Gap" compared to Standard Flats**
**FY 2013-FY 2015**
(Cents)

| | FY 2013 Unit Cont. | 2013 Gap with Flats | FY 2014 Unit Cont. | 2014 Gap with Flats | FY 2015 Unit Cont. | 2015 Gap with Flats | Gap Percentage Change |
|---|---|---|---|---|---|---|---|
| HD/Sat Letters | 8.1 | **14.9** | 8.5 | 17.6 | 8.3 | **18.2** | 22.1% |
| HD/Sat Flats & Parcels | 9.6 | 16.4 | 10.0 | 19.1 | 7.7 | 17.6 | 7.3% |
| Carrier Route | 6.2 | 13.0 | 7.6 | 16.7 | 6.4 | 16.3 | 25.4% |
| Letters | 9.3 | 16.1 | 10.3 | 19.4 | 10.7 | 20.6 | 28.0% |
| **Flats** | -6.8 | --- | -9.1 | --- | **-9.9** | --- | --- |
| Parcels | -54.0 | 47.2 | -52.5 | 43.4 | -40.2 | 30.3 | -35.8% |
| EDDM-R | 10.3 | 17.1 | 12.3 | 21.4 | 11.6 | 21.5 | 25.7% |
| Standard Mail | 7.9 | 14.7 | 8.7 | 17.8 | 8.3 | 18.2 | 23.8% |

In FY 2015, it is very discouraging for mailers of **HD/Saturation Letters** to know that every piece **earns** a hefty **8.3 cents**, but this contribution was more than offset by **9.9 cents** in **losses** from each and every piece entered as a **Standard Flat**.

### 4. The Coverage of HD/Saturation Letters Has Remained High as Coverage of HD/Saturation Flats & Parcels Has Declined

Table I-6 compares cost coverages of HD/Saturation Letters and HD/Saturation Flats & Parcels. Generally, the cost coverage of HD/Saturation Letters has remained high — well above 200 percent — while the cost coverage of HD/Saturation Flats & Parcels has been declining and is now well below 200 percent. In FY 2008, the coverage of HD/Saturation

Flats & Parcels exceeded HD/Saturation Letters by 26.4 percentage points. Now, in FY 2015, the relationship was reversed, and HD/Saturation Letters paid a 45.2 percentage point higher coverage than HD/Saturation Flats and Parcels. *See* Table I-6. Valpak can recall no discussion by the Postal Service in any docket as to whether this reversal is the result of an intentional Postal Service policy.[11]

**Table I-6**
**Standard Mail Saturation Products**
**Cost Coverages**
**(FY 2008 – FY 2015)**

| | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|---|---|---|
| HD/Sat Letters | 230.8% | 216.0% | 212.8% | 221.2% | 222.2% | 235.8% | 238.0% | 218.5% |
| HD/Sat Flats & Parcels | 257.2% | 239.6% | 224.4% | 213.6% | 217.3% | 229.0% | 227.6% | 173.3% |

Of course, some of the reason for this reversal in coverage could be the result of cost changes. For example, unit costs of HD/Saturation Flats & Parcels increased at three times the rate of increase of HD/Saturation Letters over the past four years. *See* Table I-7.

[11] For example, neither the Postal Service's January 15, 2015 Notice in Docket No. R2015-4 nor the FY 2014 ACR contain any discussion of the relative pricing of HD/Saturation Letters and HD/Saturation Flats & Parcels.

**Table I-7**
**Standard Mail Saturation Products**
**Unit Costs (FY 2012-FY 2015)**
**(cents)**

| | FY 2012 Unit Costs | FY 2013 Unit Costs | FY 2014 Unit Costs | FY 2015 Unit Costs | FY 2012-2015 Change | Percentage Change |
|---|---|---|---|---|---|---|
| HD/Sat Letters | 6.24 | 5.98 | 6.19 | 7.00 | 0.76 | 12.2% |
| HD/Sat Flats & Parcels | 7.65 | 7.43 | 7.81 | 10.47 | 2.82 | 36.9% |

**Table I-8**
**Standard Mail Products**
**Percentage Non-exigent Price Increases**

| | R2011-2 | R2012-3 | R2013-1 | R2013-10 | R2015-4 |
|---|---|---|---|---|---|
| HD/Sat Letters | 0.615 | 2.298 | 2.059 | 1.325 | 1.979 |
| HD/Sat Flats & Parcels | 0.403 | 2.121 | 2.092 | 1.124 | 1.796 |
| SM Overall | 1.739 | 2.041 | 2.541 | 1.607 | 1.926 |

Table I-8 shows that in all but one of the last five CPI-based price increases, HD/Saturation Letters received a higher percentage price increase than HD/Saturation Flats & Parcels. Although the shift of the coverage burden to HD/Saturation Letters may not rise to a violation of 39 U.S.C. § 101(d), to the extent that the Commission issues a remedial order with respect to Standard Mail Flats (as discussed in Docket No. ACR2014, Valpak Initial Comments, Section VII), the Commission should provide that any offsetting price changes first move HD/Saturation Letters coverage downward, to bring it at least into parity with HD/Saturation Flats & Parcels.

**G. This Is the Last Chance for the Commission to Prove that the Commission's Pricing Scheme Developed Under PAEA Was Not A Failure.**

The Commission's FY 2010 ACD remedial order for Standard Flats directed the Postal Service to report to the Commission certain information at each general market dominant price adjustment and in each subsequent Annual Compliance Report. The Postal Service has been extremely reluctant to provide that information or has been less than transparent in its required reporting.

In this ACR, the Postal Service identifies several operational changes that it claims will "make its processing of Standard Mail Flats and Periodicals mail more efficient." FY 2015 ACR at 18. Nevertheless, the Postal Service cannot identify any actual reductions to costs, and explains that it "is unable to provide an estimate of the financial impacts of these operational initiatives," although it does provide some metrics to help monitor "the overall efficiency of the operations monitored." *Id.* at 19. The "metrics may be modified or discontinued … other metrics may be added [and] are aggregate in nature, crossing different mail classes and entry make-up." *Id.* Nothing the Postal Service has identified is specific to Standard Flats and certainly nothing has helped (or helped enough) as Standard Flats total unit costs continue to increase, apparently unabated.

Likewise, the Postal Service identifies three costing methodologies effecting Standard Flats that were changed in FY 2015. Each change resulted in an increase in costs for the product, but in no way they account for the substantial increase in costs over FY 2014. *See id.* at 28-29.

Finally, the Commission directed the Postal Service to provide a schedule of above-average price adjustments for Standard Flats. The Postal Service simply states that it plans again to increase Flats by at least 1.05 times CPI, but fails to mention that it does not intend to have a CPI-based price increase in 2016. *See id*. at 30. In fact, removal of the exigent surcharge will amplify the inadequate pricing of Standard Flats. Thus, not only will there be no help from pricing in 2016, the Postal Service seems to be counting on the Commission to discard the price cap in its upcoming 10-year review of the regulatory system.

Despite the Commission's clear instruction to improve Standard Flats coverage, the Postal Service has eliminated any gains that it made during some of the years since FY 2010. The discussion of a remedy should not get bogged down on an all or nothing approach — *i.e.*, a price adjustment to achieve immediate cost coverage vs. making no progress towards coverage. *Any material* progress would be better than what has happened since the FY 2010 ACD remedial order. The five years under that order have shown it to be woefully inadequate and itself not in compliance with PAEA.

The inability of either the Postal Service or the Commission to make sufficient improvements in the product's costs leaves a more dramatic pricing order as the only option (other than outright elimination of the product — which is permissible under § 3653(c)). The Postal Service's recalcitrance to increase prices more than the token "CPI times 1.05" leaves the responsibility directly with the Commission to order a meaningful, effective, adequate, and statutorily compliant pricing remedy. The Commission's failure to order a new, effectual remedial action would be clearly arbitrary or capricious. The court's decision in Gamefly v.

Postal Regulatory Commission demands a remedy that fully addresses the Postal Service's illegality.

## II. THE POSTAL SERVICE NEEDS ACCURATE COSTING TO DEVELOP ECONOMICALLY EFFICIENT PRICE SIGNALS.

### A. The Significance of Good Costing for Good Pricing.

Just last week, Valpak filed extensive Initial Comments[12] addressing the UPS Costing Proposal One in Docket No. RM2016-2. Many other parties also filed lengthy Initial Comments in that docket, showing the deep concern that mailers have about accurate postal costing. Most of the points that Valpak made in those comments are directly relevant to this Annual Compliance Review, and therefore Valpak incorporates by reference those Initial Comments, and summarizes some of the points most relevant to the Commission's current work in this Docket below.

Postal costing methodology deserves significant attention for a number of reasons, both for sound economic reasons and for good business reasons. Succinctly, costs that are appropriately defined (from an economic perspective) and accurately measured are a necessary prerequisite to developing prices that encourage economic efficiency and, concurrently, improve the Postal Service's finances.[13] Even though accurate costing is necessary to achieve good pricing, having accurate costs alone is not enough, for, as we have seen for many years,

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[12] Docket No. RM2016-2, Valpak Initial Comments (Jan. 27, 2016).

[13] As Dr. Panzar explains, "[m]arginal costs are an essential ingredient in the pursuit of any policy objective for the regulated firm. Regardless of the objective of the firm or its regulator, appropriate pricing policy requires reliable estimates of each product's marginal cost." Docket No. RM 2016-2, Panzar Declaration on behalf of Amazon Fulfillment Services, Inc., p. 9.

postal pricing can virtually ignore postal costs. It is prices that are the important determinants of economic behavior, not costs *per se*. Consumer demand reacts to prices that suppliers charge, not to suppliers' costs. Pricing should be an exercise that builds on economically efficient costs, not an exercise detached from costing. It is the Commission's role in this docket to ensure that the Postal Service is not allowed to continue to set arbitrary prices, ignoring costs, as developed more fully below.

### B. Differences between Competitive Products and Market Dominant Products.

In highly competitive markets, such as those faced by most of the Postal Service's competitive products, the link between costs and prices is necessarily strong, because any suppliers who price incorrectly tend to be eliminated, either via bankruptcy or from takeover by stronger firms that adhere more closely to fundamental economic principles.

However, when an effective monopoly exists, as is the case with the Postal Service's market dominant products, the monopolist can price in an arbitrary manner. Here, the role of the regulator in overseeing prices is significantly more important than for competitive products where the market imposes its own form of discipline on the Postal Service. For market dominant products, where there is a monopolistic market, the Postal Service has the power to set prices that in no way could be considered economically efficient. In monopolistic markets, the linkage between cost and price can be weak and idiosyncratic, as the Postal Service's capricious pricing practices have demonstrated amply, in the exigent rate case as well as other rate adjustment dockets.

For example, some products, such as HD/Saturation Letters (and to a lesser extent, HD/Saturation Flats & Parcels), have been consistently priced far too high, particularly when viewed in terms of their already high profitability (with the coverage for HD/Saturation Letters now at 218.5 percent) and high elasticity of demand. Contrast Postal Service pricing of HD/Saturation Letters with its pricing of Standard Flats, the latter being a product with low elasticity, which inevitably are charged a non-compensatory price that is intentionally set substantially below marginal cost, without any economic justification whatsoever.

Economists generally agree that pricing decisions should be based on marginal cost, with the important caveat that the price of each product should at least equal the **product's incremental cost** (defined as all costs which the product causes the Postal Service to incur, and that would be avoided if the product were withdrawn). In other words, the **price floor** should be incremental cost, which usually *exceeds* **attributable cost**.[14] This means that the revenue shortfall of underwater products, which is computed as the difference between attributable cost and revenue, will be underestimated vis-a-vis a floor determined by higher incremental cost.

Non-compensatory prices that are below the level of attributable cost, which is a proxy for marginal cost, have no role in development of economically efficient price signals, and those who have been responsible for the Postal Service's pricing decisions should be so advised by the Commission. If Congress had intended Postal Service pricing for Market Dominant products to be unconstrained, it would have given the Commission no role to review prices annually for compliance with law and no tools to order compliance. Having been given an

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[14] "The CRA methodology defines attributable costs in a way that only partially aligns with the economic definition of incremental costs. **In general, CRA attributable costs understate economic incremental costs** when, as appears to hold for many Postal Service cost segments, marginal costs are declining over the relevant range of output. Docket No. RM2016-2, Panzar Declaration on behalf of Amazon Fulfillment Services, Inc., p. 8 (emphasis added).

important role and powerful tools, if the Commission fails to conduct a meaningful annual review, ordering prompt and meaningful remedial action when underwater products are identified, the entire regulatory scheme established by PAEA is undermined. The Commission's allowing the Postal Service to exercise unconstrained "pricing flexibility," is one of the principal reasons that the Postal Service is back on the Comptroller General's "high risk" list.[15] One would think that having the Postal Service appear on that list would not just be a warning sign about the Postal Service, but a warning sign that the Commission has not been doing its job, as it repeatedly has sanctioned pricing that is both economically inefficient and illegal.[16]

### C. Who pays for Losses from Underwater Products?

Of course, mailers who use underwater products enjoy receiving the wrong price signals, so they over-consume that product, possibly even switching to that cheaper product from other profitable products. And when their subsidy is challenged, they will invoke virtually any argument to continue to have their for-profit business operations subsidized.

For many years, the Postal Service has not appeared to care that it is being financially harmed by underwater products — because the Postal Service has developed two techniques to lay off the losses onto others:

- **Penalize all mailers.** The last time that Postal Service finances suffered, the Postal Service sought and received higher, exigent rates. If the Postal Service

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[15] *See* GAO Report, High-Risk Series: An Update, GAO-15-290 (Feb. 11, 2015), http://www.gao.gov/products/GAO-15-290.

[16] *See* Docket No. ACR2014, Valpak Initial Comments, Section IV.

had not deliberately lost many billions on underwater products for many years — almost $11 billion since FY 2008[17] — it would have had significantly less need for an exigent increase to ride out the "great recession." Since the exigent increase was imposed on an across-the-board basis, all mailers were forced to pay the penalty for the Postal Service's harmful pricing policies.

- **Penalize Profitable Standard Mailers.** Even without an exigent pricing increase, mailers of profitable products are regularly and routinely harmed by underwater products — particularly products within the same class of mail. If price increase authority was focused on underwater products, the price increases for other Standard Mail products would be reduced — and price levels themselves could be reduced. The Postal Service would not have needed to charge prices reflecting a coverage of 218.5 percent to HD/Saturation Letters if it did not need to make up for the $522 million it lost on Standard Flats in FY 2015.

When mailers have been wrung out by paying these subsidies, the Postal Service can always appeal to Congress to get bailed out, for no one believes that the Postal Service will be allowed to go out of business. Ultimately, it will be taxpayers that are handed the bill for underwater products, and Congress will understand the Commission's critical role in allowing those losses to continue.

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[17] *See* Appendix, *infra*.

Clearly, no one at the Postal Service pays any penalty for allowing underwater products to continue. The salaries and bonuses[18] (and, as this practice has now continued for years, retirement benefits) of those making irrational pricing decisions continue without penalty. The same could be said for the Commission.

These are terrible problems, but are within the power of the Commission to fix. The Commission can mandate using incremental costs as a price floor under all market dominant products. That mandate would at once eliminate cross-subsidies, which play no role in efficient resource allocation. Fundamental equity considerations militate against cross-subsidies, because they require some mailers to cover the out-of-pocket deficit caused by other mailers. It should be needless to say, the existence of cross-subsidies distorts economically efficient price signals. For that reason, among others, cross-subsidies for well-established products have few intellectual defenders.[19] Recipients, of course, can be expected to make every effort to defend strenuously the largess of the subsidy which they receive — each year paying for their lobbying in support of continued subsidies funded by the very illegal subsidies they are receiving.

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[18] UPS identified what may be a perverse Postal Service incentive system which rewards revenue, even if it correlates with money-losing products. *See* Docket No. RM2016-2, Valpak Initial Comments at 14.

[19] Panzar states, for example, that "When a multi-product firm has economies of scale and scope, it is entirely efficient for the firm to pass through most (or even all) of the economies to customers in competitive markets through lower prices, **as long as the rates paid by the competitive customers cover the marginal and incremental costs of serving them.**" This statement allows no room for prices that fail to cover marginal and incremental costs. Docket No. RM2016-2, Panzar Declaration on behalf of Amazon Fulfillment Services, Inc., p. 14 (emphasis added).

### D. Who Pays Unattributed Costs?

The Postal Service is a multi-product organization. It has a large amount of **unattributed** volume variable costs, described by some as **"inframarginal"** costs. *See* Docket No. RM2016-2, UPS Proposal One. In addition to these inframarginal costs, the Postal Service also has billions of dollars of **unattributed institutional** costs that do not vary with volume. According to the FY 2015 CRA accompanying this year's ACR submission, **unattributed costs of all market dominant mail products amounted to $21.6 billion, or 45.5 percent of the revenue generated by those products**. For all market dominant mail, in order for revenues to cover attributable costs in FY 2015, **an average coverage of about 183 percent was required**. Consequently, it is widely recognized that the prices of many products need to exceed marginal cost by a substantial amount in order to generate revenues sufficient to cover total costs and keep the organization financially solvent and self-sustaining. The necessity to generate so much revenue via markups over cost leaves considerable room for pricing decisions that are far removed from "economically efficient."

### E. The Underwater Pricing Problem Cannot Be Deferred to Docket No. RM2016-2.

Much of the detailed discussion about cost methodology in Docket No. RM2016-2 reflects concern that costs be attributed to products only on a causal basis. Any attribution without a strong causal link is described typically as "arbitrary," hence is to be avoided by simply leaving unattributed all common and joint volume variable costs, *e.g.*, inframarginal volume variable costs. This procedure provides a "clean" cost basis for pricing decisions. Concurrently, however, it also increases the total amount that needs to be recovered through markups on marginal cost. Prices established for individual products of course are the final outcome. The proverbial fly in the ointment is that if markups and the resulting prices are not economically efficient, they can undo the most rigorous and careful cost analysis by incorporating markups that are arbitrary, or capricious, or opportunistic, and that purposely avoid all pertinent considerations of marginal revenue and elasticity of demand.[20] From the perspective of economic efficiency, the result of a markup that is arbitrarily high or low (one that lacks any economic justification), can be just as bad, even worse, than cost attribution based on some procedure that goes beyond a narrow causal analysis. Thus far, the discussion in Docket No. RM2016-2 has largely avoided the important issue of how the Postal Service should go from efficient attribution of costs to economically efficient prices. Indeed, that docket cannot be counted on to solve the problem of pricing — that is an issue which should, and must be addressed now, by the Commission, in context of this Annual Compliance Review.

## III. POSTAL SERVICE PRICING OF STANDARD MAIL PRODUCTS PROVIDES MAILERS WITH WRONG SIGNALS AND MIS-ALLOCATES RESOURCES.

The Postal Service appears not to possess any formal pricing model for market dominant products, most especially a model that incorporates consideration elasticity of demand and marginal revenue. A recent report by the Office of the Inspector General ("OIG"), "Market Dominant Price Adjustment Filings," Report Number CP-AR-16-003 (Jan.

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[20] Such pricing drives alternatives such as Proposal One of UPS in Docket No. RM2016-2.

13, 2016) states that the pricing group does not have any model which they update and use on a consistent basis. According to the OIG:

> **The Pricing department did not have documented and repeatable processes** to guide the preparation of price adjustment proposals filed with the PRC. The Pricing department developed prices based on **institutional knowledge** and data and economic analyses. Based on their **experience** and analyses, they understand which products are at risk of a significant decrease in volume when prices increase. [*Id.* at 6 (emphasis added).]

The Postal Service's setting of prices on the basis of what the OIG refers to as "institutional knowledge" and "experience" would appear to be little more than a euphemism for arbitrary and capricious pricing. Implicit in this description is that the Pricing department regularly gives short shrift to the Postal Service's estimated elasticities of demand for all of its various products. Based on observed adjustments submitted in pricing dockets under PAEA, the OIG's description would appear to be reasonably accurate. The Postal Service has never proffered a model designed to show the maximum contribution that might be available from its recurring price adjustments.[21] Under the circumstances, it should come as no surprise that Postal Service prices provide wrong signals and are economically inefficient. The Postal Service's own contribution and finances suffer as a result.

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[21] The Postal Service claims to have a model developed by Christensen Associates which shows that if contribution is not a consideration, and the negative effect of underwater Flats on net contribution is ignored, gross revenue may be sustained at a higher level than would exist if increasing net contribution were given priority. Backsliding and recidivism in the level of contribution by Standard Flats demonstrates the inadequacies and predictive failure of that model Docket No. ACR2012, Scenario Analysis for Standard Mail Contribution, in USPS-LR-FY12-43.

In this year's ACR, the Postal Service is on the verge of admitting that the result of its policy to set the price of underwater products below marginal cost is irrational and harmful to the Postal Service:

> when unit contribution is negative, **volume growth will necessarily increase the aggregate contribution shortfall.** [*Id.* at 31 (emphasis added).]

This statement serves as an acknowledgment, or admission, that **when contribution is negative, a diminution in volume of underwater products will increase aggregate contribution**. It should be obvious that charging a price 20 percent below attributable cost sends mailers a dysfunctional signal, but the Pricing department fails to take note.[22] A non-compensatory price for an underwater product encourages more volume (and revenue) than would a higher price, *i.e.*, a price equal to or greater than attributable cost. And, as the Postal Service explains, that higher volume also reduces the contribution shortfall by increasing losses. Sending such inefficient price signals clearly mis-allocates resources. As a result, the Postal Service expends too much effort on processing and delivering Standard Flats. If Standard Flats are among the products "at risk of a significant decrease in volume when prices increase," the Pricing department ought to use its knowledge to help reduce the aggregate contribution shortfall.

What also needs to be recognized is that in price adjustments the Postal Service strives to utilize virtually all of its price cap space. Because of this, and the fact that increases in the

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[22] The Pricing department apparently believes that the statute designates the Postal Service to be protector of all legacy products that either cannot or will not pay their cost of distribution.

price of underwater products are artificially constrained, the prices of profitable products are increased more than they would be otherwise. Those higher-than-necessary price signals on profitable products are equally inefficient. They also lead to mis-allocation of resources, *e.g.*, the Postal Service has less volume of other far more profitable Standard Mail products if they were priced appropriately. The result is a reduction in net contribution.

The CRA reports average revenue received for all market dominant products. The CRA also reports a coverage for each market dominant product. Some, such as HD/Saturation Letters, had a very high coverage in FY 2015 (218.5 percent), while underwater Standard Flats had a coverage of only 80.2 percent, which was substantially below the breakeven coverage of 100 percent, and hence is generally referred to as a negative coverage.[23] This negative coverage indicates that Standard Flats fail to cover even their marginal costs, much less *their incremental costs*. From an economic perspective, pricing any product below its marginal cost is irrational, and when such pricing is allowed to continue year after year, the scenario becomes completely inexplicable. Nevertheless, in the FY 2015 ACR, the Postal Service attempts to provide vague rhetorical cover for its irrational pricing by stating that:

> As the Postal Service has stated in the past, it agrees with the Commission that having products cover their costs is an appropriate long-term goal. [*Id.* at 17 (emphasis added).]

The two products most used by catalogers are Standard Flats and Carrier Route. Together they illustrate how Postal Service sends wrong price signals to mailers. Comparing

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[23] According to the FY 2015 ACR, the average revenue of Flats was 40.1 cents, and their attributable cost was 50.1 cents. The subsidy received by Flats was the 9.9-10.0 cents per piece difference.

volume data in this year's ACR with last year shows that the volume of deeply underwater Standard Flats increased, while the volume of Carrier Route, which is profitable, decreased, *i.e.*, profits from Carrier Route declined while losses from Standard Flats increased. Such a result indicates that pricing of flat-shaped products gave rise to the wrong outcome for the Postal Service in FY 2015. With the exigent surcharge scheduled to expire in April, it would be appropriate for the Postal Service to elevate the prospect of all cost coverages exceeding 100 percent to **a real short-term goal**, because continuing deficits by underwater products will erode very quickly any remaining surplus after expiration of the exigent surcharge.[24]

## IV. THE POSTAL SERVICE SHOULD BE DIRECTED TO ADOPT MARGINAL COST PRICING FOR ALL STANDARD MAIL PRODUCTS.

Every market dominant product has an attributable cost, which can be considered a reasonable proxy for marginal cost. Four of the six Standard Mail products have a coverage that exceeds 100 percent. The fact that the price of most Standard Mail products exceeds marginal cost does not mean, though, that coverages of the various Standard Mail products in any way reflect marginal cost pricing by the Postal Service. Quite the contrary.

For any product with a normal downward sloping demand curve, marginal cost pricing requires that price **exceed marginal cost**.[25] There is no economic case for setting price equal

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[24] At expiration of the **exigent surcharge**, the Postal Service will have received **$4.634 billion** of additional revenue. Docket No. R2013-11R, Order No. 2623 (July 29, 2015). From enactment of PAEA through FY 2015, Postal Service losses on **underwater products** have far exceeded $10.7 billion (as measured from attributable costs, not incremental costs). *See* Appendix Table A-1, *infra*.

[25] Technically, price should be set according to demand at a point above where marginal revenue is equal to marginal cost. *See* Valpak's Initial Comments in Docket No. RM2016-2.

to or below marginal cost. Further, if a product's **incremental cost** exceeds its marginal cost, then incremental cost should act as a floor for the product's price, *i.e.*, price should exceed marginal cost. The continued pricing of underwater Standard Flats, where revenue is only about 80 percent of attributable cost, is convincing evidence that the Postal Service rejects the use of marginal cost pricing.

The proposal for an across-the-board percentage increase in the exigent rate case (Docket No. R2013-11), where the rate cap did not apply, is further evidence that Postal Service pricing typically ignores all considerations of demand elasticity (at least as estimated by the Postal Service's own econometric model) even when the class-based cap did not apply. That across-the-board proposal constitutes a *de facto* decision to reject marginal cost pricing.

The Standard Flats product clearly was not in compliance with the statute in FY 2015. Importantly, it will not be in compliance until the Postal Service's Pricing department adopts a rational economic pricing policy, such as marginal cost pricing. The Postal Service's Pricing department should be directed to adopt marginal cost pricing for all products in Standard Mail now, **with no exceptions**. That would implement economists' original rationale for their proposal to develop and use marginal costs for pricing decisions. That also would mean that unprofitable products receive substantial price increases, while highly profitable products **with relative higher elasticity**, such as HD/Saturation Letters & Flats, should get only minimal price increases (if any) in rate adjustments until demand becomes more inelastic, but this has not been the case. If the relative price level were to be restrained, the relatively high elasticity of HD/Saturation Letters indicates that volume and contribution would increase more than for other products that have lower coverage and a relatively lower elasticity. The Commission was given the power to order remedial prices be implemented to cure illegal pricing by Congress. 39 U.S.C. § 3662(c). It has a duty to use that power in this docket to order dramatic increases in the price of deeply underwater Standard Flats, extinguishing the crippling losses, and ending the madness.

## V. THE COMMISSION SHOULD GIVE SERIOUS EXAMINATION OF, AND DIRECT THE POSTAL SERVICE TO EMPLOY, THE VALPAK STANDARD MAIL CONTRIBUTION OPTIMIZING MODEL.

Unlike the Postal Service, which the OIG reports has no pricing model[26] which can be identified, Valpak has developed, and repeatedly proposed such a model. In Docket No. ACR2013, Valpak submitted an optimizing model based on linear programming principles. This model was resubmitted in the ACR for FY 2014. The model enables computation of the maximum contribution obtainable within the available rate cap space. The model is sufficiently versatile to enable development of contribution-increasing alternatives that do not necessarily maximize contribution. While resources have prevented a complete update of this model, should the Commission or the Postal Service desire to use the model for the purpose intended, it can be updated readily to incorporate the most recent data available. *See* Docket No. ACR2013, Valpak Initial Comments on USPS FY 2013 ACR (Appendix and Valpak Multiyear Model_v2013.xls (filed 1/31/2014)). Moreover, Valpak would be pleased to assist either the Commission or Postal Service in achieving a better understanding this model and applying it.

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[26] OIG, "Market Dominant Price Adjustment Filings" at 1.

Respectfully submitted,

/s/
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# APPENDIX

## Table A-1
## Losses on Market Dominant Products Under PAEA
## (Exclusive of Special Services)
## FY 2008-2015
## (millions)

| **Product** | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total |
|---|---|---|---|---|---|---|---|---|---|
| First-Class Parcels | — | — | — | — | $10 | $3 | — | — | $13 |
| Inbound Int. Single-Piece First-Class Mail | $102 | $105 | $53 | $33 | $93 | — | $54 | $98 | $538 |
| Standard Mail Flats | $218 | $616 | $577 | $643 | $528 | $376 | $411 | $522 | $3,891 |
| Standard Mail Parcels | $165 | $205 | $172 | $112 | $49 | $35 | $31 | $24 | $793 |
| Periodicals Within County | $4 | $13 | $24 | $19 | $28 | $21 | $18 | $23 | $150 |
| Periodicals Outside County | $434 | $629 | $587 | $590 | $642 | $500 | $490 | $497 | $4,369 |
| Single-Piece Parcel Post | $64 | $61 | $134 | $88 | $66 | $23 | N/A | N/A | $436 |
| Bound Printed Matter Parcels | — | $7 | $27 | $4 | — | — | — | — | $38 |
| Media and Library Mail | $58 | $74 | $89 | $98 | $56 | $56 | $20 | $85 | $536 |
| **Total** | **$1,045** | **$1,710** | **$1,663** | **$1,587** | **$1,472** | **$1,014** | **$1,024** | **$1,249** | **$10,764** |

Sources: FY 2008-2014 ACDs, FY 2015 ACR.